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SUBJECT: THE BAJNAI PACKAGE: REAL REFORM AT LAST OR MERELY  
"BRUTAL" AUSTERITY MEASURES?

REF: BUDAPEST 275

11. (SBU) Summary. Prime Minister Bajnai announced details of his HUF 1.3 trillion (USD 4.6 billion) economic recovery plan, which involves substantial cuts to social welfare programs, ministry budgets, and public sector workers' benefits. The plan also includes a shifting of the tax burden away from labor to wealth and consumption. Analysts are cautiously optimistic, noting that if Bajnai is able to successfully implement the plan it will enable Hungary to meet its deficit targets and help improve Hungarian competitiveness. The opposition Fidesz Party criticizes the package as focusing too much on spending cuts and not enough on tax relief, while public sector unions believe the plan benefits the interest of big capital at the expense of workers. We expect to see an increasing number of strikes and demonstrations in the coming months, as unions and other groups adversely impacted by the austerity package express their opposition. Although continuing to call for early elections, most believe it is to Fidesz's benefit to allow Bajnai's government to undertake necessary but unpopular reforms. End summary.

#### THE BAJNAI PACKAGE

12. (U) This week, Prime Minister Bajnai announced additional details of his economic recovery package (reftel). The package aims to cut state spending by HUF 400 billion (USD 1.7 billion) in 2009 (around 1.5 percent of GDP), and HUF 900 billion (USD 3.9 billion) in 2010, in order to keep the budget deficit at 3 percent based on a new macroeconomic projection of a 5.5 to 6 percent decline in GDP for 2009.

13. (U) The package includes the following spending cuts and changes to the pension and social welfare system:

#### GOH spending cuts:

- eliminating the so-called "13th month" public sector bonus;
- freezing public sector wages for 2 years;
- lowering local government subsidies;
- reducing government ministers' salaries by 15 percent, and salaries of state company executives even further;
- cutting per diem rates for official trips abroad;
- cutting ministry operating budgets.

#### Changes to social benefit system:

#### Pensions:

- increasing the pension age from 62 to 65 beginning in 2012;
- eliminating the 13th month pension, beginning this year, and introducing a premium pension linked to GDP;
- eliminating the so-called "Swiss indexation" of pensions;

-eliminating rules that make early retirement attractive.

Social subsidies:

- 10 percent cut in public sector sick leave payments;
- freezing the family allowance for two years, lowering the eligibility limit from age 23 to age 20;
- reducing the number of years families are eligible for certain allowances from 3 years to 2;
- phasing out and then eliminating gas and central heating subsidy;
- suspending state home building subsidies.

Other spending cuts:

- eliminating the public transport subsidy;
- eliminating the media subsidy;
- cutting the national co-financing of EU agricultural subsidies

14. (U) In addition to these expenditure cuts, Bajnai outlined a number of tax and contribution changes for 2009 and 2010 that are intended to shift the tax burden from labor to consumption and wealth, and to create greater incentives for working and the full reporting of wages.

2009 Tax and contribution changes:

- five percent cut in employers' welfare contribution, and establishing a contribution ceiling double the minimum wage;
- increasing the lowest personal income tax bracket to HUF 1.9 million (USD 8,260) per year;
- increasing the VAT rate from 20 to 25 percent, and creating a new 18 percent rate for dairy, bread, and other staples;

2010 Tax and contribution changes:

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- reducing the lower personal income tax bracket rates from 17 percent to 15 percent, and the upper bracket rates from 35 to 33 percent;
- five percent cut in employers' social benefit contributions;
- combining gross wages and contributions into a new personal income tax base;
- introducing a property tax based on property value;
- eliminating the 4 percent "solidarity tax" and establishing a uniform corporate tax (reportedly to be increased from 16 percent to 19 percent)

AN ATTEMPT AT REAL REFORM...

15. (SBU) A number of Bajnai's proposed changes - such as changes to the pension indexation system and the family allowance system - include cuts in areas previously thought to be too politically difficult to address. Analysts are cautiously optimistic, and many believe the proposed tax and social benefit changes will help improve Hungary's competitiveness. They agree that the measures should enable Hungary to keep its 2009 deficit close to 3 percent as long as GDP does not decline beyond the projected 5.5 - 6 percent.

16. (SBU) Several analysts point out, however, that Bajnai's plan does not address other urgently needed reforms - like reform of the political party financing system and the system of local government - but recognize that many of these reforms would be difficult to achieve during the expected short duration of his tenure, as well as requiring a two-thirds majority in Parliament.

17. (SBU) Despite the favorable reaction, analysts quickly pointed out that implementation remains the key issue, and many questioned whether Bajnai would be able to secure and maintain the political support necessary to implement his program. As one analyst noted, Bajnai's plan "attacks the core electorate of the de-facto still ruling Socialist Party," whose support is necessary for the plan to succeed.

...OR BRUTAL MEASURES?

¶18. (SBU) The main opposition Fidesz Party described Bajnai's austerity measures as "brutal," and several Fidesz economic experts, like former Finance Minister Gyorgy Matolcsy and former Finance Minister and National Bank Governor Zsigmond Jarai, have criticized the Government's plan for focusing too much on spending cuts and not enough on reducing taxes and administrative burdens on businesses. Matolcsy noted that, "a program of recovery from the crisis should start with job creation, with growth resulting from this, and then it can be followed by restoring balance. The Bajnai government is following logic totally contradictory to this." Parliament Budget Committee Chair and former Fidesz Finance Minister Mihaly Varga adds that "the austerity resembles the 2006 Gyurcsany package, and is bound to fail, just like that one did."

¶19. (SBU) Public sector employee and trade union groups have expressed opposition to the plan, maintaining that the proposed cuts are unjust and favor the interests of big capital over impoverished workers. Public sector unions have announced plans to strike on April 30, and for demonstrations on May 1.

¶10. (SBU) In announcing his plan, Bajnai made clear that the austerity measures "will be hard to accept," and "things will get worse before they get better," and called for solidarity in implementing the plan. On the other hand, Bajnai promises that "if we implement (the reforms), we shall come out of the crisis faster and much stronger".

COMMENT:

¶11. (SBU) Despite the positive reaction from analysts, markets in Hungary have not reacted strongly to the Government's plan. Concerns remain about whether Bajnai will be successful in enacting his reform package and whether Socialist Party MPs will continue to support it as their constituents increasingly feel the effects. Demonstrations by those impacted by the austerity measures are likely to increase through the Spring, and Bajnai will face pressure to back away from some of his proposed measures.

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¶12. (SBU) We expect Fidesz to continue its low grade assault of Bajnai's plan, and to continue to call for early elections. Many believe, however, that Fidesz benefits more by letting Bajnai undertake politically unpopular reforms prior to the 2010 elections, as long as the reforms result in the economy rebounding and not the Socialist Party's popularity.  
Levine